The Changing Language of Business

An Honors Thesis (HONRS 499)

By

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Abstract

For several years now there has been growing concern regarding U.S. adoption of new accounting reporting standards. The International Financial Reporting Standards, IFRS, have been developing more and more popularity and have become the leading contender as a single, global method of financial reporting. This paper seeks to examine American neighbors and consider their course of action as an example for possible U.S. action. It attempts to define a realistic timeframe for U.S. conversion. It discusses where in the financial reports users will notice differences between the old U.S. Generally Accepted Accounting Principles, GAAP, and the new standards. Should America decide to switch, this paper presents what challenges the U.S. will encounter along the way and what benefits will be waiting on the other side.

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The Language of Business

1. Introduction:

As any accounting student could attest to, the language of business is accounting. Soon the language that accountants speak to each other will be changing. Americans still speak the United States' domestic Generally Accepted Accounting Principles (GAAP). However, this language is no longer the same as many other countries. The language of International Financial Reporting Standards (IFRS) is sweeping the globe. Soon the U.S. will stop translating and start learning this new tongue.

The question becomes how much longer the U.S. will retain GAAP. This move towards international compliance of a single GAAP has been a long time coming ever since the start of global commerce. Businesses buy, sell, and trade in foreign countries every day, all the while translating the sales being recorded overseas. For some time now, the number of countries reporting under the new standards has been growing. Even now, America's neighbors are making the switch.

This paper seeks to explore the actions of other nations in order to set an example for U.S. conversion. It also attempts to anticipate when Americans can expect a switch to IFRS as mandated by the Securities and Exchange Commission (SEC). It will locate areas of the financials, namely, the Balance Sheet and Income Statement, which will be affected by the differences between standards. It recognizes the fact that it is no simple matter to change a country's reporting standards; it is costly and time consuming. While there are some tough issues to consider and difficulties to overcome, the immediate benefits vastly outweigh the intermediate costs.

The following also strives to convey the imperative need for accounting students and professionals to educate themselves on the implications of new standards. However, they are not the only ones who will need to be aware of the changes. Every citizen who uses the information reported on the financials, whether directly or indirectly, must understand how accountants arrive at the numbers presented in order to make informed investing decisions. Educating Americans on the changes will naturally require a great deal of time. SEC Chairman Christopher Cox stated, "It may be a very long time indeed before the world's 6.5 billion people can all speak in the same tongue. Fortunately, we won't have to wait that long for the language of business and finance to converge" (Shiry, 1).

2. Actions of foreign countries:

On a global scale, convergence to IFRS has been ongoing for many years. IFRS made its first large appearance back in 2005 when the European Union began to require IFRS-based reporting for all publicly held European-based companies (Epstein, 27). It didn't take long before Europe was not the only one requiring IFRS reporting. Nowadays nearly one hundred countries either require IFRS or have a plan to converge (Gill, 70). This number will continue to rise in the coming years. It is estimated that by 2011, less than 50 percent of the Global Fortune 500 will be using U.S. GAAP as their financial reporting standard (Bell, 18). Among those who have plans in place for convergence are Japan, China, and India (Gill, 70). As of this year Israel officially transitioned as did Chile and Korea (Shiry, 1). The number of countries with IFRS futures is growing and will continue to grow ever more rapidly each year. U.S. neighbors are adopting the new standards as we speak. Canada is scheduled to transition in 2011 (Epstein, 26).

Another matter to consider when examining those countries which have switched before us is whether or not they truly adopted IFRS. Adoption is defined as utilizing IFRS in place of national standards. In contrast, convergence is a process of merging national standards and IFRS until they are parallel standards (Nobes, 281). As far as users of financial statements are concerned, knowing and understanding this difference, could be vital to their investment decisions. One downfall of convergence is that in order to converge, both IFRS and national standards must be amended. When IFRS makes amendments based on the convergence, it affects much more than the one country: all users of the standards are affected. On the other hand, if IFRS does not change during convergence and only the converging nation amends its standards, this is off balance convergence (Nobes, 282).

Many of the well-known adopters of IFRS do not in fact conform to IFRS. The vast majority of countries who claim to have switched actually require their own national version of IFRS (Nobes, 279). Different nations use different descriptions of their standards. The audit reports in the E.U. went through many revisions of how to disclose what standards were in practice such as, "in accordance with IFRS as adopted for use in the E.U.," and ended on calling their version EU IFRS. The phrasing is very important when considering that International Accounting Standard 1 "Presentation of Financial Statements" states in paragraph 16 that no company is allowed to declare usage of IFRS unless it meets all of the requirements (Nobes, 284).

Regional versions or not, the overwhelming action towards global adoption of IFRS seems to be evidence enough of the direction in which reporting standards are moving. The only country, it seems, that has not converged with the new movement is the U.S. With the amount of importance Americans place on international commerce, the question becomes: when will the U.S. make the transition to IFRS?

3. Timeframe of U.S. conversion:

Initially, when IFRS first came on the scene, U.S. GAAP was the most popular method of financial reporting. The expected outcome between U.S. GAAP and IFRS was that GAAP would outlast the new standards and remain the most popular reporting standards. Once the SEC realized that this was not the case, it started work towards merging the two (Bell, 19). The popular view of U.S. adoption/conversion with IFRS is echoed across the country saying, "The question is seemingly no longer 'if', but 'when' the United States will adopt International Financial Reporting Standards" (Baker, 6). Having recognized the inevitable, the Financial Accounting Standards Board (FASB) began work with the International Accounting Standards Board (IASB). Several years ago, in 2002, the two organizations formed a commitment known as the "Norwalk Agreement" to make the two reporting standards compatible (Gill, 71). Later, in 2006, both issued a formal "Memorandum of Understanding" to the public which set goals and affirmed their continued efforts of merging (Gill, 71).

More recently, the SEC has published the "Roadmap for the Potential Use of Financial Statements in Accordance with IFRS by U.S. Issuers" which proposed to make IFRS mandatory for large public companies by 2014 (Heffes, *Considering* 14). One of the steps in this roadmap is to make a final decision regarding whether or not adopting IFRS would be beneficial to investors by 2011 (Lehmann, 14). The mandatory date proposed in the roadmap seems a long ways off, but Americans could see public companies reporting in IFRS much sooner. There is a possibility that the SEC would allow some companies to early adopt before 2014 (Bell, 19). Early adoption would only be allowed by the SEC starting in 2010 when an industry as a whole uses IFRS more often than any other reporting standard (Barlas, 24).

The 2014 mandatory date in the roadmap would only be the start of transitioning companies. Large, accelerated companies would be required to file under IFRS for the year ending December 2014, but smaller companies would not be required to file under IFRS until 2016 (Barlas, 24). Robert Hertz, the chairman of the FASB, believes that full convergence could take anywhere from 10 to 15 years to complete. He mentioned that most of this time will be spent by the FASB and IASB merging the standards, but even after they have completed their combined mission, there will still be differences between the standards which will require additional time to sort out (Heffes, *When* 12).

There are many issues to examine when considering the U.S. adopting IFRS, including: how, when, how to prepare, education and certification of professionals, tax issues, effects on private and not-for-profit entities and the future role of the current governing body, FASB (Baker, 6). Many ideas have been proposed as to how best convert current GAAP users to IFRS such as mandating the switch and phasing in the new standards over a period of several years with the large companies being the first to switch (Baker, 6). This long process has been in the works for years and as recently as 2007 a major step towards U.S. acceptance of the standards was made when the SEC decided to no longer require foreign companies to reconcile to GAAP (Baker, 6).

When considering when to converge in the U.S., a big decision to make is who should switch. Regulators must decide what is to be required of the private, smaller companies. One idea is that many of the smaller companies would be held to different standards: "In essence, there would no longer be a uniform concept of GAAP, but a GAAP as applied to different types of entities" (Baker, 8). Public companies would report using IFRS, smaller and medium sized companies would report under a simplified version of IFRS and there would be separate standards for not-for-profit and government entities. The IASB proposed a separate standard be issued entitled, "International Financial Reporting Standard for Private Companies," which would apply to private companies regardless of size. In the case of not-for-profit entities, IFRS was not intended for their use and it is not likely the SEC would require them to switch. Governmental entities are also not included in those to switch to IFRS; therefore, they would continue to report under the current Governmental Accounting Standards Board (Baker, 8).

Experts on the subject, such as Sir David Tweedie, chairman of the IASB, have weighed in on America's process of adoption. Tweedie believes that the recent economic environment in the U.S. has reduced interest in IFRS, but that once the SEC mandates conversion, interest will surely resume. He also stated that inaction by America towards IFRS could "diminish American influence on the global economy" (Heffes, *When* 12). If American companies intend to remain competitors in the global arena, they must make it easy for investors to compare their financials with those of foreign companies. This is accomplished by publishing the financials in the same reporting language: IFRS. Lawrence Gill put it best when he said, "IFRS is unquestionably and inexorably in the future of American CPAs and the future is now" (73).

4. Major Differences:

Since it seems inevitable that the U.S. will adopt some form of IFRS the next major issue to discuss would be where American CPAs and investors could expect to see differences between GAAP and IFRS. In 2007, Ernst and Young published a survey of 130 foreign companies' reported differences following their first year of adoption of IFRS. While this will not be identical to what American companies may find, the research gives American companies and investors a good idea of what to expect. The following is a table of their findings listed by category and number of reported differences:

IFRS vs. U.S. GAAP - Overview of Differences

Category	***Number of Differences***
Business combinations	258
Financial Instruments - recognition and measurement	126
Financial Instruments - shareholder's equity	41
Financial Instruments - derivatives and hedge accounting	159
Pensions and post-retirement benefits	311
Share-based payment	152
Provisions and contingencies	125
Impairment	87
Foreign currency translation	90
Intangible assets	45
Capitalization of borrowing costs	47
Leasing	61
Revenue recognition	46

(Callaghan, 12).

Many of these items are the result of a change in method of accounting for these items under IFRS. In other cases these differences arose from the classification of items between GAAP and IFRS (Callaghan, 12). Either way, this study shows just how much of a change Americans can expect.

The overall approach IFRS takes to presenting the standards is principles-based whereas GAAP is a rules-based approach. This means that under IFRS, there will be more interpreting to do of the standards. GAAP was very specific on what items were to appear and while IFRS mandates that certain items be displayed on the balance sheet and income statement, it does not prescribe a specific format for these minimum items (Gill, 72).

Looking specifically at the financials, one major difference is valuation. Starting in the asset section of the balance sheet, the inventory item will be seeing a big change in valuation in that IFRS does not allow the use of last-in-first-out inventory measurement. Also, GAAP currently does not allow an entity to reverse inventory write downs, but IFRS would allow some reversals in certain situations (Gill, 72). Property held for investment as an item is treated the same way by both GAAP and IFRS, but IFRS would allow entities to account for the property's fair value and treat changes in that fair value as gains and losses (Gill, 72). Another asset, plant property and equipment (PPE), could see changes as a result of IFRS allowing a company to elect a method of reevaluating PPE's fair value and treating a decrease as an expense and an increase as a credit to a revaluation account under the condition that all assets of the same class are treated in the same manner (Gill, 72).

Treatment of certain costs will also change under IFRS. The costs of borrowing for qualifying assets under GAAP were capitalized, but under IFRS the entity could elect to capitalize or expense these costs. Similarly, pre-operating costs are assets on the balance sheet under GAAP; however, IFRS will require these costs to be expensed, removing the asset (Gill, 72). Research and Development costs as defined by IFRS will also be expensed such as; costs of materials, employee costs, purchased intangibles, purchased services, and indirect costs (Gornik, 42). According to the author; "The requirement that all R&D costs incurred internally be expensed immediately is a conservative, practical solution, which insures consistency in practice and comparability among companies" (Gornik, 44). Extraordinary items, due to their definition under GAAP, do not occur very often and would be eliminated by IFRS (Gill, 73).

The large number of differences for business combinations seen on the table above results from the change of date for fair value measurements, recognition of contingent consideration, treatment of research assets, and recognition of restructuring provisions (Callaghan, 10). This difference in revenue recognition could be caused by the difference in guidance (Gill, 72). Accounting for post-retirement benefits would be affected when recognizing actuarial gains and losses between GAAP and IFRS (Callaghan, 12). Some changes regarding impairment arose from reversal of write-downs, evaluating long-term assets, and assessing goodwill for impairment (Callaghan, 13).

Financial instruments will also reflect some reporting differences between GAAP and IFRS. IFRS has a different set of definitions and requirements for financial instruments which leads to different classification of these items. Derivatives, partial-term hedges, and non-derivative hedging instruments all will have differences in reporting (Callaghan, 12). Some of the other differences that will present themselves are related to tax such as classification of deferred tax and treatment of share-based payments (Callaghan, 14).

5. Challenges to switching:

Due to these differences and many more, the adoption of IFRS in the U.S. will be an enormous adjustment for all financial statement users. There will be many challenges to converging with the new standards during this adjustment phase. It will not be just accountants who need to be educated on the new regulations: anyone who works with accounting information will need to change their way of thinking from accountants to regulators to educators and court officials (Baker, 8).

U.S. companies that operate outside U.S. borders have a couple considerations to make regarding IFRS. First is to be conscious of regulated convergence, and second is to consider switching early to keep up a competitive comparison with other international companies (Heffes, *Global* 14). When the company does elect to switch, even though the end result will make things much easier, the transitional period will demand a great deal of hours from the accountants who will have to prepare both local GAAP and IFRS financial statements for a period of time (Heffes, *Considering* 14). In fact, the true transitional period is the year before the year of the mandated switch because that is when accountants will need to update account balances in order for them to be adequate beginning balances under IFRS (Heffes, *Considering* 15). During this additional workload, companies will need to make staff considerations such as bringing in additional personnel and training their current employees to understand the switch (Heffes, *Global* 14). Some companies elect to employ a full time IFRS project office (Heffes, *Considering* 15).

The cost of switching to new standards will be a huge burden to companies; especially considering the current economic state. The SEC estimates that year one costs for IFRS will be roughly one million dollars for every one billion dollars the company makes in revenue (Heffes, *Considering* 14). Looking to Europe as the example of switching, often times European companies spent more time and resources on the transition than was initially estimated. The expenditure can be broken down into several categories, "other cost components include identifying differences, determining accounting policies, maintaining multi-GAAP financial reporting systems for three years, implementing new accounting systems, and associated changes in internal controls and drafting the multi GAAP financial statements" (Heffes, *Considering* 15).

Switching reporting standards is far more than simply publishing financials under new regulations. Timothy P. Flynn, Chairman of KPMG International noted, "Systems and processes related to data collection and financial reporting controls must be evaluated and revised so that IFRS becomes ingrained in companies' processes" (Heffes, *Global* 14). The new standards must be taken into consideration in every operation of the business even when making decisions regarding contractual terms, risk management, treasury operations, and management consideration (Heffes, *Global* 14). These are just the challenges of switching standards as applies to business practices, but many of the challenges also lie in practicing the new regulations.

One of the new concepts under IFRS is applying fair value to accounts which will take a major adjustment on the part of U.S. accountants (Heffes, *Considering* 14). Then, in turn, the users of the new financial statements will have to evaluate the fair value measurements when making investing decisions. Auditors also will need to closely evaluate these measurements to assess their reliability. The audit process as a whole will need to be updated to make sure it reliably evaluates financials and detects fraud under new standards (Heffes, *Global* 15). Undoubtedly, there will be some confusion as the adoption is made. For example, following the switch, new pronouncements will be published that did not exist under U.S. GAAP. One of these new pronouncements already enacted regards measuring biological assets at fair value, but how to determine that value could be very difficult (Baker, 9). It will take some time to decipher and to become comfortable with changing measurement styles.

In a country where lawsuits are a common occurrence, the thought of trusting professional judgment may be hard to accept. “For this to work, the legal and regulatory authorities in the U.S. must allow auditors to exercise reasonable professional judgments that are not subject to excessive second-guessing or, even worse, to litigation” (Heffes, *Global* 15). The problem of potentially turning to lawsuits to settle disagreements on correct interpretation of the new standards is a very serious challenge to adopting IFRS. As mentioned before, IFRS are principles based standards rather than the rules based standards Americans are used to seeing in U.S. GAAP and present gray areas left up to analysis (Baker, 9).

Once the entity has adjusted its accounting practices to take into effect the changes, the next major challenge is what effect these changes will have for tax purposes. As one author points out, "Conversion to IFRS will have tax effects that go far beyond changes to accounting results" (Bell, 19). Unfortunately, the tax code requirements do not always change to reflect changes to accounting methods. The best example of this dilemma is accounting for inventory. The last-in-first-out method is not allowed under IFRS, but U.S. tax code requires this method for financial reporting if it is used for tax purposes (Baker, 9). Either the tax code will need to be amended or IFRS will need to be adjusted for such problems.

Moving from GAAP to IFRS will be a "massive undertaking" by much more than just accountants (Heffes, *Global* 14). One of the less than obvious groups of people affected by the new standards is the academia. Part of training the accountants is educating the accounting students in the classrooms. The group tasked with determining whether accountants are qualified to work under the new standards is those who write the exams for CPAs. The accountants must prove they are knowledgeable in IFRS in order to properly serve the companies mandated to switch in the future.

The vice chairman of Marshall and Stevens, Al King, expressed his concerns regarding the "massive undertaking" saying, "Mandating a switch to

IFRS from GAAP is going to require massive resources at a time when the economy is none too strong…" (Barlas, 24). Undeniably, the U.S. companies are not in the best position to take on an additional expense right now. Hopefully, the economy makes a comeback and by the proposed 2014 date companies can handle conversion costs.

6. Benefits of new standards:

Past the challenges, there are many benefits to converting to IFRS. The main problem with each country following its own GAAP is that the act of reconciling the financials to another countries' decreased assurance in the quality of those statements. Having uniform standards will foster international business relationships, lower cost of capital, and reduce accounting risk (Epstein, 26). The way in which IFRS lowers cost of capital is by decreasing risk. IFRS is essentially lowering the estimation risk that occurs when investors try to estimate the likelihood of a companies' return (Daske, 333). When there is less risk involved, investors will accept a lower rate of return; therefore, the company pays less to acquire the funds necessary for operating its business. Accounting risk comes from a lack of understanding of the principles of reporting and whether or not they are being followed (Epstein, 27). IFRS could help decrease this risk as well because when all countries use one language, investors have an easier time of reading a greater number of financials and do not need to be versed in several versions of GAAP.

There is also evidence to support "that uniform financial reporting standards will increase market liquidity, decrease transaction costs for investors, lower the cost of capital, and facilitate international capital formation and flows" (Epstein, 31). All of this means that one set of standards will make international trading much smoother. The increase in liquidity is derived from increased disclosure under IFRS. In particular, the increased disclosure of stock liquidity is a great advantage for companies because the decreased risk in this case eliminates part of the need for companies to sell stock at a discount (Daske, 333). One set of standards also greatly reduces the amount of complexity and cost of preparing statements for domestic and international purposes (Heffes, *Global* 14).

In 2001, the IASB adopted a due process identical to the one used by the FASB which has greatly improved the quality of its standards (Epstein, 27). This increases assurance in the accuracy of financial reporting and also aids in opening trade of securities (Epstein, 28). As mentioned before, the IFRS are a principles-based set of standards and some argue this too increases quality (Heffes, *Considering* 14). Regarding this change one author states: "The shift from rules-based U.S. GAAP to principles-based IFRS is intended to improve transparency and comparability in global markets" (Heffes, *Considering* 14). Good financial reporting is transparent and timely and there is general agreement that IFRS can accomplish these goals (Epstein, 28).

In regards to the change IFRS makes in valuation, that it requires fair values measurements, the general consensus is that this change could be for the better. Some say: "IFRS does a better job of recognizing the fair value of corporate assets—essentially 'unlocking value' of the corporation by recognizing previously unrecognized, cash generating assets under U.S. GAAP" (Heffes, *Considering* 14). In the weakened U.S. economy, the fair value measurements may actually be a more relevant method of valuation (Heffes, *Global* 15).

Another reason for the assertion that international standards are more reliable comes from the increased number of mandatory disclosures. IFRS has more information content specifically in the reported earnings (Daske, 333). Citigroup Inc. did a study comparing reports from 73 European companies who publish both GAAP and IFRS financials and found that under IFRS over 80 percent of those companies had higher net income and returns on equity (Heffes, *Considering* 14). Since the U.S. was not one of the first countries to adopt the new standards, it has the benefit of observing what other countries have chosen to do.

7. Conclusion:

IFRS's overwhelming popularity as evidenced by the sheer number of adopting countries proves that it is a set of standards that will be in practice for many generations to come. The number of U.S. neighbors converting to this method of financial reporting is sure to continue to grow in the following years. Since GAAP is losing its popularity at such an astonishing rate, the only option for the U.S. is to converge. If the U.S. does not act, America will indisputably lose a substantial amount of influence in the global arena. Equally as vital is the risk of American companies losing standing as global competitors. This risk is too great to take. In this economy, American companies cannot afford to give away potential investors.

The time for action is now. Companies need to make preparations for transitioning to the new reporting standards. Every day that American companies wait to publish their financials under IFRS is another day foreign investors doubt the stability of the company because of the lack of comparability to other nations' financials. Countries with lower standing in global commerce have already made the move and are better off for it. Instead of putting off the inevitable, America should embrace the change and converge now before the U.S. gets left behind.

As for the differences to adjust to under IFRS, those can be amended or be a positive change for U.S. accounting. American GAAP should be converged with IFRS and the process of merging the two reputable sets of standards could smooth out some of the differences America would have trouble adopting; such as the inventory methods conflicting for financial and tax purposes. Because the U.S. will converge, adjustments could be made to IFRS that would be more tailored to American style accounting; a U.S. IFRS. However, some of the large differences should remain for America to adopt. The fair value method of measurement has been proven to unlock value for companies and this added value will be a welcome addition. The current economy is such that an increase in net income would also be a positive change. Furthermore, because of the volatile economy, the fair value measurements will more accurately measure the true value of a company's assets leading to better quality reporting.

Unfortunately the cost to convert to the new standards will be great. It will be a challenge for businesses suffering from the weakened economy to find funds to train employees. They will also need to gather information from previous years in order to have beginning and comparable balances for current financials. The process of interpreting IFRS for each company alone will create a large demand on accountants' time. In spite of this large expenditure, the cost of not converting would be even greater. Struggling businesses cannot afford to lose customers and investors on top of their diminished sales.

Americans should be encouraged by the advantage created by the U.S. not converging before now. American leaders can look to the examples set by other transitioned nations as to how best adopt changes. Once the U.S. conforms to the new standards, Americans will have firmly established themselves on the international commerce scene.

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